PD-ABN-986
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# PROGRAM CLOSE OUT

## SUPPORT FOR DEVELOPMENT PROGRAM II
## (PROJECT NO. 492-0450)

USAID/PHILIPPINES

APRIL 28, 1997

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UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT/MANILA

# *Memorandum*

April 28, 1997

TO: The Files

THROUGH: James L. Mudge, OME

FROM: Gil R. Dy-Liacco, PRM

SUBJECT: Program Close-Out - Support for Development Program II (SDP II) (492-0450)

REFS: (a) Nathan Associates Inc., Evaluation of the Philippines Support for Development II Program, August 1995; (b) IMCC, Synthesis Report: Assessment of Technical Capabilities of Selected Philippine Financial Institutions, April 1995; (c) AYC Consultants, Inc., An Evaluation of Nathan Associates Inc. Technical Assistance for Inter-island Shipping Deregulation 1992-1994, August 1996; (d) IMCC, Final Report on Technical Assistance to the Philippine Bureau of Treasury, November 1996; and (e) SDP II files at Office of the Mission Economist and the Office of Financial Management

## 1. **Purpose**

The purpose of this memo is to provide a summary close out report for the Support for Development Program II (SDP II) based on the documentation contained in the references listed above.

## 2. **Background**

### A. Origins and Program Design

Since 1986, the United States, as part of its aid program, has made grants from development assistance funds, the Multilateral Assistance Initiative, food aid, and the Economic Support Fund (ESF) to the Government of the Philippines (GOP). The ESF grants served the dual purpose of providing resources to the budget and the balance of payments on the one hand and furthering the process of policy reform on the other, by conditioning their release on the achievement of specific measures. The immediate ancestor of SDP II, the first Support for Development Program, disbursed $209 million in 1989 and 1990 and had a substantial effect on the balance of payments.

The initial design of SDP II called for $120 million. However, the Mission's overall funding levels were reduced, and the amount was reduced to $60 million. Signed on September 30, 1991, SDP II was a cash transfer grant program with formal policy conditions. The dollar cash transfer assistance amounting to $56 million was to be provided in three tranches, the first two for $18.5 million each and the third for $19 million, as balance of payments (BOP) support and to service official national government non-military debt to the U.S. Government and to multilateral lending institutions. The remaining $4 million were to provide funds for technical assistance, policy studies, limited commodities, training to implement SDP II, and evaluation and audit. SDP II, together with other grant agreements involving cash transfers, also helped the GOP meet its commitment to provide the A.I.D. Mission with local currency for operating expenses for calendar year 1993.

## B. Program Policy Objectives

In 1991, when SDP II was being designed, the GOP and USAID/Manila reached a consensus that the program would be more effective if it were focused on one goal. Therefore, the GOP accepted the USAID mission's goal of improving the competitiveness of Philippine exports. Repeatedly, in the past, growth had been cut off because the growth of exports had been insufficient to pay for the necessary imports. More competitive products would not only help solve this problem but improve efficiency in the economy as a whole, widen opportunities for private enterprise, and increase employment.

The broad purpose of the different measures agreed to by the GOP was either to increase the return to or reduce the cost of production of the exporter:

- The first and most important measure was to create an interbank market that reflected the supply and demand for foreign exchange and to liberalize the exchange control system so that businesses and individuals would be freer to make their own decisions. It was expected that by making the exchange rate more market responsive it would become more realistic, increasing the price incentive to sell abroad.

- The second measure was to reduce the time required to issue duty drawbacks and value added tax (VAT) refunds from almost 2 years to 60 days so the drawbacks could become an effective incentive to exporters rather than being eroded by the interest paid on borrowed funds while waiting and by processing costs.

- The third measure was to develop a small savers instrument that, by tapping a new source of funds to finance the budget, would tend to lower the overall costs of interest rates. This measure was never put into effect although an excellent report was completed. Some spare funds were reallocated to improve the functioning of the Bureau of Treasury (BTr) of the Department of Finance (DOF).

- The fourth measure was to induce more competition in interisland shipping rates to reduce the cost of bringing export goods to their port of embarkation.

C. <u>Implementation Benchmarks</u>

SDP II's three tranches were disbursed in three releases:

- The first tranche of $18.5 million was disbursed at the end of 1991.

- The second tranche also amounting to $18.5 million was released towards the end of 1992 following a three-month extension of the terminal date for the conditions precedent for this tranche. The extension of the terminal date for the second tranche was due to a delay in meeting an indicator on interisland shipping.

- The third and last tranche of $19 million was released in October 1994, after the terminal date for meeting the conditions precedent was extended six months on three consecutive occasions: from June 30 to December 31, 1993, from December 31, 1993 to June 30, 1994, and from June 30 to December 31, 1994. The first extension was due to a delay in meeting two indicators: the reclassification of agricultural commodities for interisland shipping services and the reduction of processing time for VAT refund applications. The second extension was granted to allow for start-up and a learning period at the One Stop Duty Drawback Center for the processing of the VAT refund. The third extension was granted to allow a longer data series on performance data on VAT refund processing time.

The SDP II program assistance completion date (PACD) was extended twice:

- The first extension was from September 30, 1994 to December 31, 1995 to allow adequate time for the completion of technical assistance activities under SDP II, i.e., institution building assistance to the new Bangko Sentral ng Pilipinas (BSP) and the BTr as the new fiscal agent of the national government.

- The second extension from December 31, 1995 to June 30, 1996 was to allow sufficient time for the delivery of technical assistance to the BTr.

## 3. **Program Evaluation**

### A. Review of SDP II Design

At the end of 1991 when SDP II was being designed, the Philippines had made significant headway toward reducing macroeconomic imbalances but still had a formidable reform agenda to carry out. At that time, structural issues affecting the country's competitiveness were as follows:

- The Philippine peso, relative to most of its competitors in East Asia, had become more overvalued since 1975.

- Labor costs were so high that Philippine industry was competitive only in the more skilled occupations.

- The country was not attractive for foreign investors in the late 1980s.

- The national investment incentive program did not favor exporting.

- Although the extreme protectionism of the early 1980s had been eliminated, most industrial and agricultural activity was still shielded by high barriers.

The objective of SDP II was to develop a series of measures that the GOP could put in place to improve export competitiveness. Essentially, the approach was to eliminate barriers to the operation of market forces - barriers that the government itself had put into place specifically or inadvertently. The tactic was to either improve the return to sales or reduce the cost of production by eliminating or modulating legal or regulatory mechanisms that stood between the producer or trader and selling prices or the cost of inputs. All the measures proposed in SDP II affected one or the other for those directly involved in exporting. The program did not address the problem of the structure of protection and its effect on the level of costs. It has been argued that the high levels of effective protection (i.e., tariffs, quantitative restrictions, and barriers to entry) are a major reason why Philippine exports are not more competitive. This issue was part of the conditionality of another USAID program (PEPS - the Private Enterprise Policy Support Program) as well as of a World Bank loan ( the Economic Integration Loan).

The emphasis was on the export of commodities rather than services. The rationale was that long-run growth potential is greater for goods than services (e.g. tourism), but that in the medium term this may not be the case.

TA for the BTr was mainly aimed at building the BTr's capability to carry out its fiscal agency responsibilities which legislation transferred from the BSP. At the same time, the Philippine capital markets were undergoing dramatic changes (many changes aided by USAID assistance), and it was important for the BTr to fulfill its capital market responsibilities concerning the issuance of government debt instruments. Therefore the TA activities were also aimed at facilitating financial sector reforms. These activities included developing the macroeconomic and financial understanding of selected BTr staff, improving staff understanding of the interaction of fiscal and monetary policies, developing appropriate procedures and structures for issuing government debt, and developing adequate cash management and debt management capabilities.

## B. Review of SDP II Implementation

The program goals for foreign exchange and refunds were accomplished within or even before the agreed schedule, with one small exception: performance on the VAT refund, which held up the release of the third tranche. The small savers instruments project was suspended after it was determined that falling interest rates no longer made it feasible.

With respect to foreign exchange liberalization, an evaluation conducted by R. Nathan Associates in 1995 found that the interbank market was much more open to market forces and more competitive in 1995 than it was in 1991. The liberalization of foreign exchange controls had been more extensive than required under SDP II, verging on *de facto* convertibility of the peso. The BSP entered into the spirit as well as the letter of the program which became a principal element in the President Ramos' policy of opening the Philippine economy to foreign investment. Although the BSP and the GOP made the decision to liberalize, A.I.D. played a strong supporting role in facilitating a more extensive foreign exchange liberalization than was initially envisaged by the GOP.

With respect to duty drawbacks and VAT refunds, the 1995 Nathan evaluation found that of the duty drawback claims in 1992-1994, 99 percent were processed within the One-Stop Shop's (OSS) own target of 30 working days from the date completed applications were received rather than the SDP II's target of 60 working days. The goal of processing VAT refunds within 60 days was achieved in mid-1994, a year behind schedule. The key to this was the transfer of VAT refund processing from the BIR to the OSS. This was done with USAID encouragement and support. The OSS is now a permanent unit of the Department of Finance (DOF), the basis for expecting a continued good performance.

With respect to the small savers instrument (SSI), a benefit-cost analysis in 1993 found that the cost of issuing SSIs would have exceeded the interest savings from doing so, given the lower T-bill rates (12.5 percent) and the rate of inflation (8.3 percent) prevailing in 1993-1994. Therefore, the program was suspended and the remaining funds allocated to technical assistance for the BTr.

With respect to increased interisland shipping competition, the policy conditions set under both SDP I and II were found to influence liberalization reforms and have resulted in market determination of some user charges. Shipment of lower classifications of agricultural commodities has increased but this due more to higher vessel capacities and not to more renumerative charges brought about by reclassification. However, the USAID supported deregulation policies by the Maritime Industry Authority (MARINA) have allowed increased competition, which consequently led to improved services and facilities for shippers and passengers. There are now more frequent trips to choose from, shipping companies have invested in better and newer vessels, and travel or waiting time has been reduced on most routes.

The technical assistance was helpful and generally appreciated. The technical assistance also included a major assessment of technical capabilities of four Philippine financial institutions, the Bangko Sentral ng Pilipinas (BSP), the Central Bank Board of Liquidators, the BTr and the Department of Budget and Management. GOP concerned agencies for the most part found the assessments useful, although NEDA disagreed with some findings on capital budgeting. (USAID had previously funded TA outside of SDP II to assess the BSP's new organization plan.) Based on recommendations for TA from the assessment of the four institutions, the Mission implemented TA for the BTr with joint financing from SDP II and PEPS.

The technical assistance to BTr had three major accomplishments: (i) a smooth transfer of fiscal agency responsibilities; (ii) a comprehensive computerization of most treasury operations; and (iii) a significant amount of training that should be long lasting. The revamped debt issuance process led to lower interest rates in the face of rising inflation, and lengthened the maturity structure of government securities. There were significant gains in reduced interest expense to the National Government. The computerization of the BTr will allow for more efficient operations. The benefits of training will accrue over many years as BTr staff are now more able to contribute to key macroeconomic and financial policy discussions.

C. Disbursements

The mechanism of transfer of SDP II funds involved cash transfer dollars. The dollars were used as stipulated, for payment of non-military debt service obligations of the GOP to the US and official debt to multilateral institutions. Existing documentation on reviews conducted by USAID staff on the GOP's disbursement of dollars from the SDP II Dollar Special Account indicate that the GOP complied with the terms and agreements specified in the SDP II grant agreement and with the SDP II dollar implementation plans.

D. Assessment of Program Impact

The economic impacts of SDP II arise mainly from the effects of foreign exchange liberalization. These are as follows:

- The unification of the official and parallel markets and the rediversion to official channels of almost all receipts that had been in the parallel market;

- A significant increase in the inflow of foreign private, and to some, extent, Philippine capital;

- A rebuilding of foreign exchange reserves to comfortable levels; and

- A decline in competitiveness compared with 1990 because of exchange rate appreciation.

With regard to duty and VAT refunds, their accelerated processing represented about 0.7 percent of the value of all exports in the 1992-1994 period. The net benefit to society from the streamlining of the system was equal to pesos $49 million.

To estimate quantitatively the economic impact of the program, the Nathan evaluation simulated each of the three aspects of SDP II - accelerated tax refunds, higher capital inflows, and appreciation of the peso - as well as of the overall impact, for the seven-year period from 1992, when the first measures were taken, through 1998.

To take into account the time value of economic costs and benefits, the Nathan evaluation employed a simple benefit-cost analysis to compare the costs of SDP II with projected benefits defined as GNP increases facilitated by the program. Annual costs included the program's direct implementation costs and its negative impacts on GNP growth during the period 1991-1994 due to peso appreciation from build-up of international reserves. The annual additional increments to GNP were measured by subtracting the "with" project forecasts from the forecasts made assuming no project. Using the GOP-recommended 15 percent social discount rate, the ratio of gross benefits to program costs was about 5:1 at constant 1985 prices. The same eight-year annual stream of net benefits in constant 1985 prices represents an estimated internal rate of return of 31 percent.

It is clear that the economy in 1995 at the time of the evaluation, compared with that of 1991, has improved in a number of ways. It has grown at a more than five percent annual rate, while the rate of inflation has fallen to more manageable levels. The budget deficit had been eliminated, at least temporarily, and interest rates have declined by about one-third. Through the combined forces of higher earnings from invisible and capital inflows, the effect of SDP II has been to finance the much larger trade deficit that growth required, and increasing exchange reserves.

With respect to the TA to the BTr, it is believed to have immediately realized significant savings in interest expenses, with 1995 interest payments $280 million less than posted in 1994 even though total debt outstanding increased during the year. Estimated annual savings could approach $1 billion under the right circumstances, which clearly generate a very attractive benefit-cost ratio for the TA. These savings also reinforce the credibility of the debt issuance process within BTr.

No quantification of benefits from deregulation of the interisland shipping was undertaken.

## 4. Assessment of the Fulfillment of USAID Objectives

How has USAID contributed to the GOP's reform efforts through SDP II?

- USAID/Manila, by choosing export promotion and emphasizing, within that goal, foreign exchange liberalization, has, independently of other donors, made an important contribution to the Ramos administration's reform program. Although other donors have expressed some interest in this subject, none has made it a major condition for the disbursement of assistance.

- By concentrating a few selected objectives united under the common theme of export competitiveness, the Mission created a clearly defined program that was simple to implement and monitor.

- Because new institutions were created as a means to reach program objectives, the results are likely to be more permanent than if the Mission required only adherence to quantitative targets or legislation as a condition for aid release. The creation of a market for foreign exchange in the context of exchange control liberalization, that is responsive to supply and demand is shaping the behavior of banks, the BSP, and exporters and importers. Liberalization has established a set of interests that reinforces that market's continued operation. On a smaller scale, the new One-Stop-Shop refund center has made duty drawbacks and VAT refunds effective incentives for exporters by shortening the length of time required for claims to be processed. Previously, delays in payment had been long enough to effectively nullify the incentive value of the program.

- Although the reorganization of the foreign exchange market did have some negative consequences for export competitiveness in 1992-1994 due to peso appreciation, the policy achieved the ultimate goal: allowing rapid growth of output and employment to occur without balance-of-payments problems.

- The most important steps to deregulate and improve the inter-island shipping industry in the Philippines have worked. Deregulation has increased the number of new vessels; increased load capacities through larger vessels and a high frequency of port calls; introduced new technology and pioneering services on major routes; and improved the quality of service on routes where two or more operators now compete.

- TA to the BTr succeeded in helping establish a sound fiscal agency function within the BTr. Domestic debt issuance and debt management have become far more efficient.

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CDIE, OME, PRM, OFM, OED, RLA

clearance:

OFM:LBrady (draft)

RLA:PSullivan (draft)

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